DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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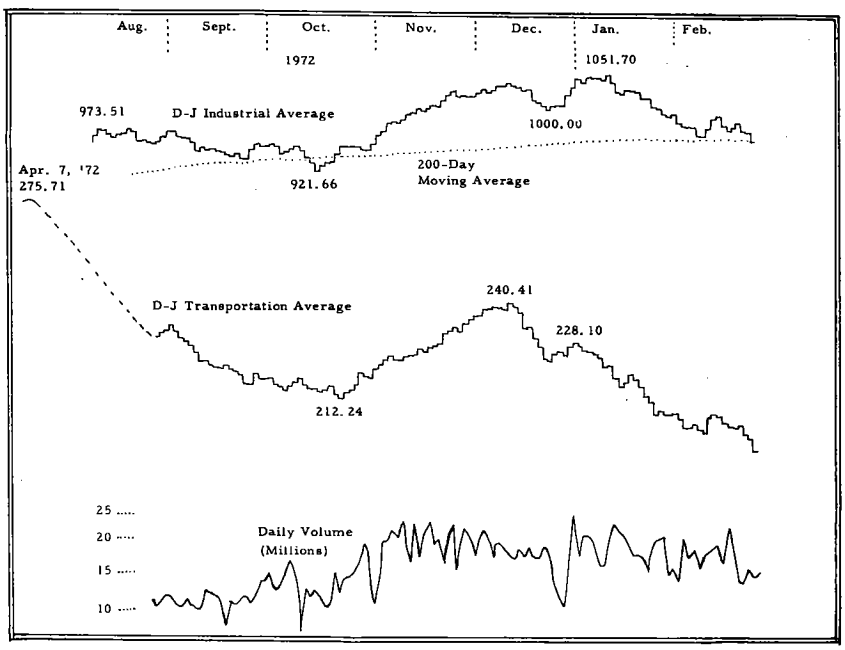
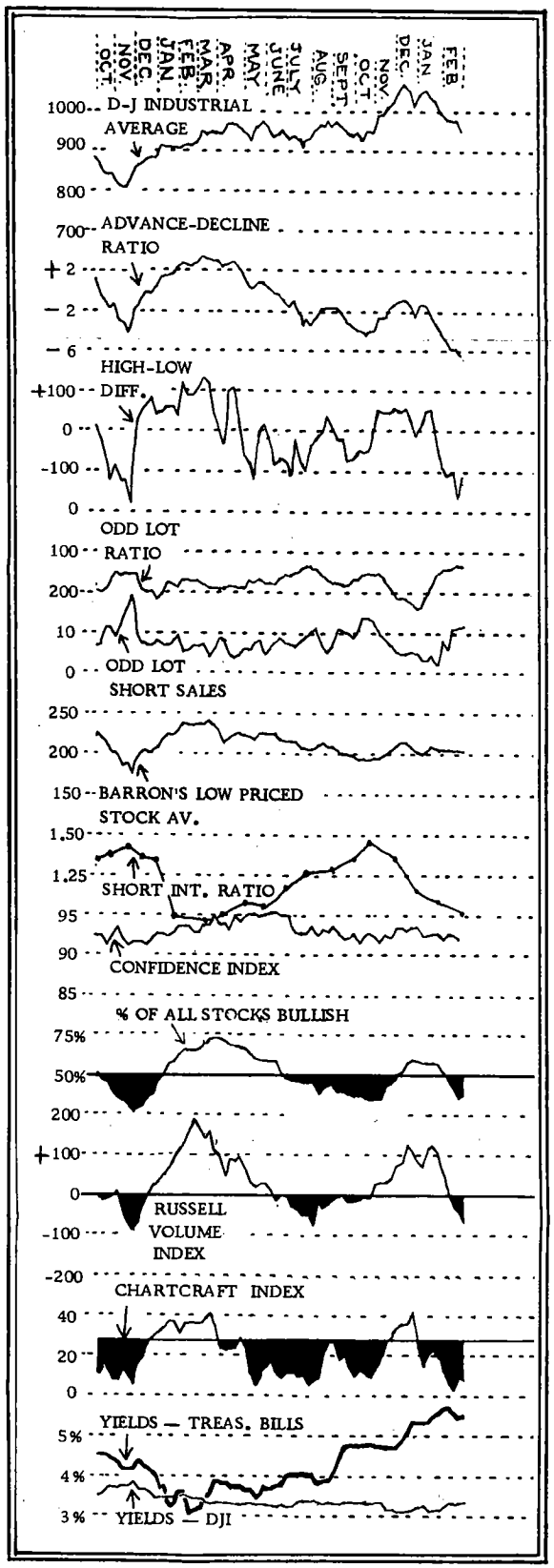
Feb. 15, DJIA 979.29, PTI 942, A-D ratio -5.80
Feb. 23, DJIA 959.89, PTI 928, A-D ratio -6.64

THE MARKET: I am beginning this Letter with two charts, each entirely different from the other but each an integral part of the total market story. One chart is purely technical, being a point & figure chart of the D-J Transportation Average. The other is as fundamental as a chart can be, for it is a "story" chart of the gold price rise from the $35 of 1971 to the current level which is considerably more than double the 1971 bargain price.

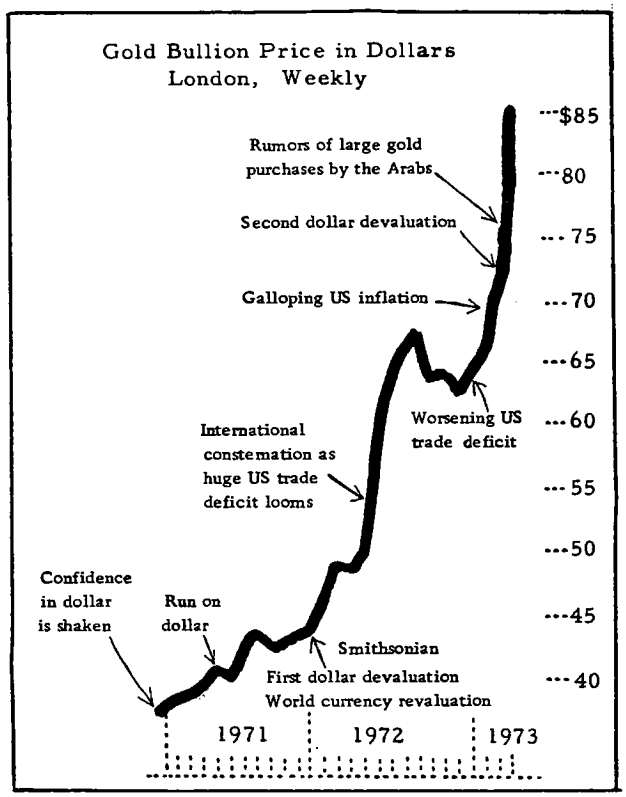
The first chart (page 2) is almost self-explanatory, and it should come as no great shock to readers of these reports. What I have presented here is a "story" picture of one of the most dramatic movements in the history of precious metals. But perhaps it would be best to accept this graph as a "fever chart" of the dollar, the kind of chart one sees at the foot of sick-beds in hospital wards. The fever is raging now with the price of gold up over $20 since the recent devaluation and up over $7 on a single day alone, Friday, February 23! All Europe, Asia, and Africa knows the US monetary fever is raging. In this country, our leaders tell us that the chart presents no cause for worry, it is simply measuring the price of a "barbaric relic." Gold is indeed a most wondrous metal, for just as some men will kill to get it, other men will lie in their teeth in an attempt to get rid of it. Both approaches, needless to say, lead inevitably to disaster.

As to the second chart, Letter 553 drew attention to the "head-and-shoulders" pattern in the Transportation Average, and I noted that this was an ominous structure. The H & S pattern is the classic pattern of distribution. It does not deal with "Why," "Because" or "How come," it deals only with what is. This P & F chart (courtesy of Chartcraft, Larchmont, NY 10538) shows all the rallies and declines in the D-J Transportation Average of six points or more from July, 1971, to date. Each box equals two points. Rallies are shown by vertical lines of X's, declines by vertical lines of O's. Technically, this is known as a 2 point-6 point reversal chart.





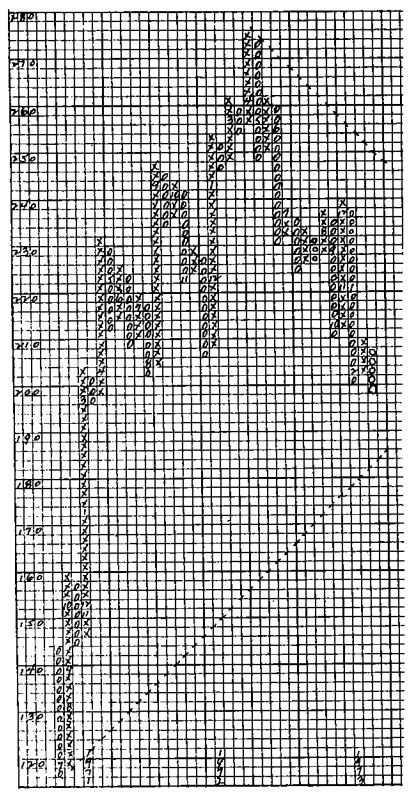
I have said that the Transportation Average is important because it represents shipping; it is the average which gauges whether we "move out the merchandise we make." If we don't move out (sell) what we produce, manufacturing (represented by the Industrial Average) is in trouble. I have noted in past Letters that the Transports were not confirming the rallying efforts of Industrials, and this can be seen clearly on the page 1 chart. From the April, 1972, peak of 275.91, the Transports have been heading persistently down. On January 11, 1973, with Industrials at an all-time high of 1051.70, the divergence became flagrant. The January 11 Industrial high found Transports 30 points under their 1972 peak. This led to the trouble the market finds itself in today.



Note on the P & F chart that the Transports had been able to hold above the August, 1971, level of 204 on all declines. This level represented the "last line of support." On February 14 the 204 barrier was finally penetrated. On February 23 (last Friday) Transports broke the 200 level on an hourly basis, thus "filling in" the 200 box on the P & F chart. This completes the total breakdown on the Transport pattern.

Many P & F chartists like to use a "count" or price objective following a significant P & F penetration. I do not usually place great emphasis on the count, but it is worth noting that the current formation (the "top" measures an amazing 29 rows across) is large enough to take the Transport Average (on a horizontal count) to just above 100. To me, the significance of this is that the Transports look very weak, and that they could go a long way on the downside.

DOW-JONES TRANSPORTATION AVERAGE



I should mention, as I did in Letter 553, that the Transports are the "speculative average," and that a collapse in Transports almost always precedes or coincides with a collapse in general speculative activity. Thus, the current crumbling of the Transports sector does not bode well for the market in general. I believe the break below 200 on the DJTA will have very adverse psychological implications for the market.

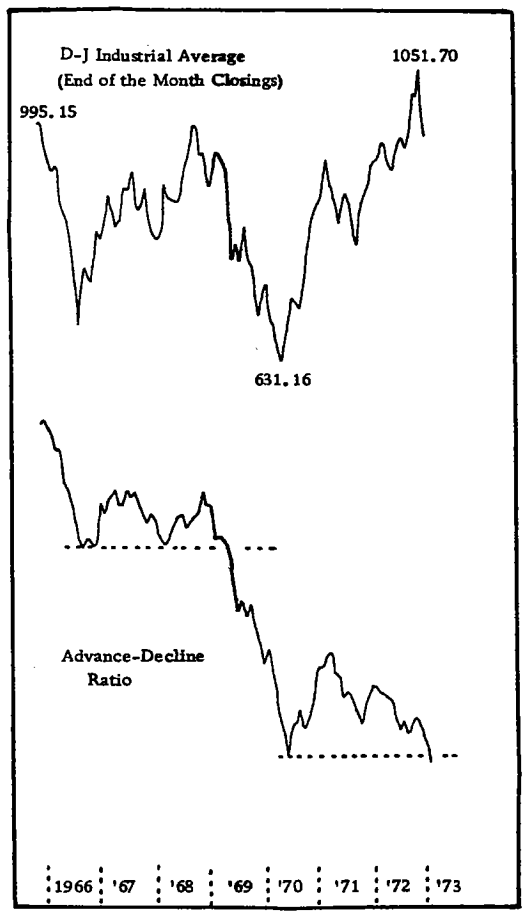
A final note here: Readers may note in Barron's ("Exchange Monthly Figures") that Customers' Equity under 40% for January was a whopping 14%. This means that margin accounts in very large numbers are nearing the "trouble zone." With daily new lows on the NYSE nearing 10% of the entire Board, this margin situation could be dynamite on the downside.

BREADTH BREAK: On February 22 the A-D ratio broke below its entire structure of the past three years, thereby rupturing its 1970 bear market bottom (see chart page 3). This is a most extraordinary penetration, comparable technically to the break in 1969 which penetrated the previous 1966 bottom (refer to horizontal dotted lines on the chart).

In the last Letter (page 4) I showed that according to one of my studies the market is now in "oversold" territory. Evidently, the current market is so weak that even the oversold condition could not prevent the A-D ratio from smashing its 1970 bottom. Based on past history, the odds would now favor a continued major decline by the A-D ratio (and probably all the leading averages) to substantially lower territory. Such a decline could materialize following a rally from the present oversold area — or, if the market chooses to stay oversold, the decline could continue as it has been doing ever since the beginning of 1973.

Obviously, those who have been holding diversified portfolios of stocks (against my advice) must now be showing losses somewhat in relation to the A-D ratio profile as pictured on the chart. For these misguided hopefuls the decline started long before "the beginning of 1973." Such holders have probably been having a hard time of it ever since 1966 or certainly since late 1968. Thus one of the most deceptive primary bear markets in history continues on its way. When the end comes, there will be few arguments about "whether we have been in a primary bear market or not."

CHURNING UP A STORM: The accompanying chart shows annual daily volume on the NYSE for every year since 1921. I feel that this chart is highly significant, particularly for the period since 1966.

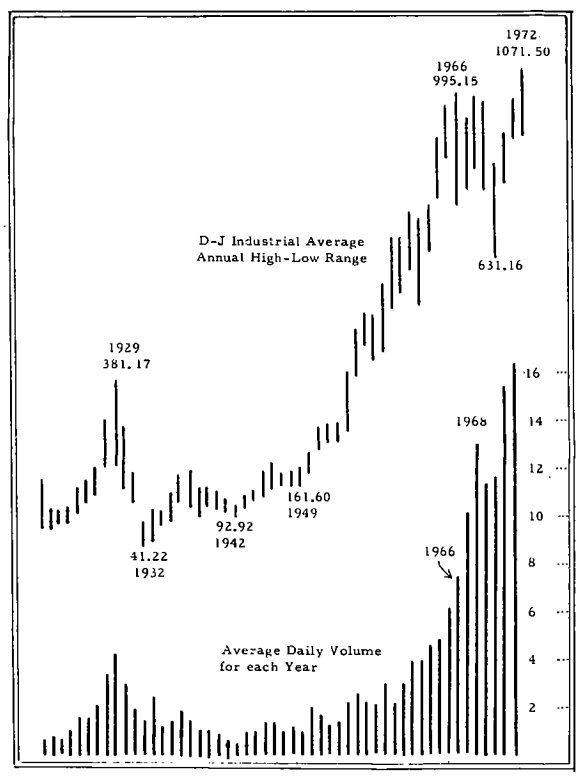


Note that volume has tended to expand almost exponentially since 1942. Obviously, this kind of "curve" upwards cannot last indefinitely, and actually since 1968 the upward expansion of average daily volume seems to have lost its momentum.

However, it is well to note that during 1966 average daily volume was 7.5 million shares. That was the year when the Dow topped out at 995.15. Last year (1972) average daily volume was 16.4 million shares or better than double that of 1966. Yet the high for the Dow in 1972 was 1051.70, and as of this writing the Dow is within a few points percentagewise of its 1966 peak.

Furthermore, based on the Value Line geometric chart (an unweighted average which measures percentage of change in over 1400 stocks on the NYSE — see chart) the average market level for almost all issues is now actually nearer the 1966 low than the 1966 high! The question — what has all this increasing volume since 1966 been accomplishing?

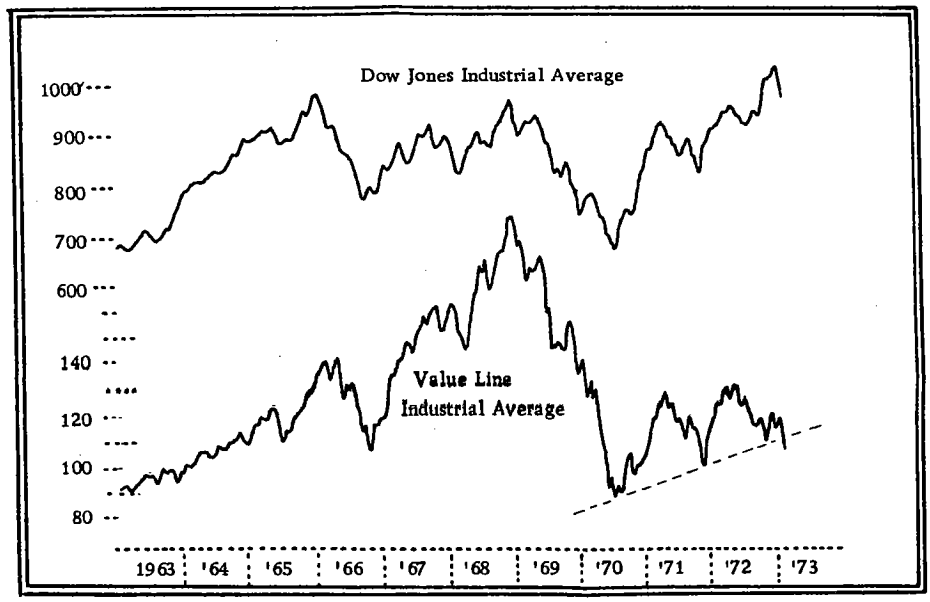
The answer on one level is not a happy one. Much of the rising volume since 1966 has been going towards liquidation of a majority of issues while the "window dressing" has been provided by the big-capitalization and selected growth stocks which are prominent in the averages. Also, with the rise of the institutions as stock purchasers (and traders) since the mid-1960's, there has been a great deal of switching around, big block trading, and massive positioning by the "big boys" of Wall Street. Yet all of this so-called professionalism has not succeeded (despite vastly increased volume) in bidding up the average level of prices.



In fact, based on Value Line's Average or even based on the progress of the Dow since the 1966 peak, a good case could be made for mass churning of stocks over the past seven years. If I had to guess I would say that based on the average daily volume chart, volume should start contracting somewhere ahead. There should be a volume correction of the vast expansion since 1942, and as stated before, the upward momentum of volume seems to have topped out around 1968.

What would a three or four year contraction of volume from the present lofty highs imply? In my opinion, such a contraction should coincide with a primary bear market. Volume, as a study of history demonstrates, almost invariably contracts with a primary decline in prices.

MONEY & GOLD: Reams of nonsense, ignorance, wishes and assorted propaganda are now being churned out regarding the latest US devaluation. Devaluation is the route of the "banana republic" just as bankruptcy is the path of the incompetent or the welscher. A strong, honest, proud nation does not follow the path of debasement of its currency, just as an honest businessman does not make his product shoddy in order to compete. A strong nation which finds itself losing its trade position (with accompanying pressure on its currency) does whatever is needed to become competitive again. It's painful but it's the honest thing to do.



One-third of the raw materials used in US production are imported, and this does not include oil or natural gas. Within twelve years one half of all the oil in the US will be imported. The devaluation means we will pay 10% more for these imports. Is this the road to US prosperity? Because of the high raw material prices paid, corporations will now want to boost their selling prices in an attempt to hold the profit line. This will put pressure on consumer pocketbooks and tend to price US merchandise farther out of world markets. Is that the road to prosperity? The devaluation cuts the value (in terms of gold) of all the 70 billion dollars held by our foreign creditors. They have been robbed again by a second US devaluation within 14 months. If you think that's the road to confidence in the US as a trading partner, forget it. It's the road to ruin for anyone holding US paper.

Even the old Keynesian London Economist (Feb. 17-23) clucks disapprovingly at the latest devaluation in an article entitled "Once More, Nixon Does the Unthinkable." The article notes, "The US continues to be one of the few countries in which just about everyone of importance thinks that a devaluation is lovely ... Devaluation has few enemies (in the US) since trade is a very small part of the total economy with imports amounting to less than 6% of the gross national product."

These are some of the facts our leaders aren't telling the American people. And here is another possibility that isn't being broadcast either. It is that there is going to be mounting pressure for trade wars against the US. The rest of the world is not going to continue to be blackmailed in order to keep US inflation-boom going, they are not going to watch their dollar reserves being debased, and they are not going to submit to devaluation announcements every time the US trade balance zooms into the stratosphere.

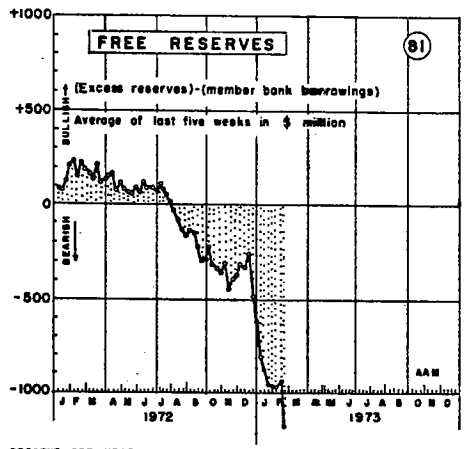
The trouble could well start in the Mid-East. I wonder myself how long the Mid-East leaders are going to be willing to trade their "Black Gold" for our green paper? Already, Kuwait has balked, and rumors are now being heard to the effect that it is the sheiks who are running the price of gold up, trading in some of their mounting hoard of devalued dollars for gold bullion via the London gold market and others. It's simply logic, and I ask every reader of these reports to consider this. You are an Arab Sheik. You are collecting huge amounts of dollars for your oil exports. The dollar has fallen twice in the past 14 months, and the underlying causes of dollar weakness are still there in spades. You can buy gold for dollars in London, Paris, Zurich. Would you resist an increasing hedge through gold bullion? Ask yourself that question.

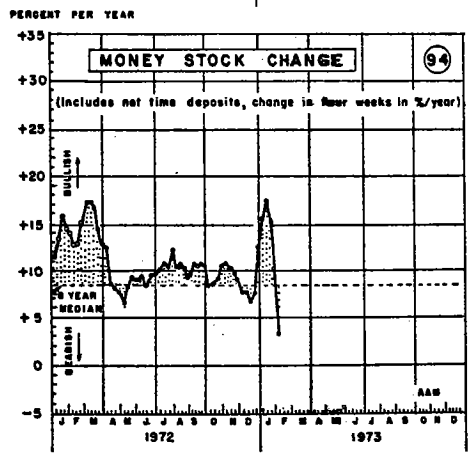
There are two important roads a nation can travel if it wishes to protect its currency. It can bring in painful, anti-inflation measures such as leveling off or actual contraction of money supply, cutting the budget until it produces surpluses, allowing interest rates to rise to their natural market levels, allow the economy to go along on a free, supply-demand level, resist bailing out inefficient or bankrupt businesses, etc. OR, it can try to manipulate the trade picture by erecting barriers against imports, trying to force special advantages for its own experts, try to bully other nations into giving it favorable trading deals. I have no doubts regarding the path the US will follow. It will follow the second path, the path of trade manipulation. The consequence will be trade wars.

Finally, we have the pressing problem of convertibility. No major power can continue to trade with an eroding currency and remain a great power. The reason is that its creditors won't hold its currency. That's where the US is now. With the current erosion of the dollar, the day the dollar is made convertible would be the day that every last ounce of gold would be called out of Fort Knox by our foreign creditors. Thus, convertibility, ample gold reserves to back convertibility, and stability (with trade surpluses) all go hand in hand. And the solution to convertibility: A fiercely competitive economy, a stable currency, a general gold inflow.

One of the most fascinating segments of the current drama comes from none other than Reserve Board Chairman, Arthur Burns. Perhaps Mr. Burns has finally noticed that the price of farm products rose on an annualized basis of 62.4% in December, 34.8% in January, perhaps Mr. Burns is following my gold chart, I don't know. At any rate he did announce that the US balance of payments must be turned around within two years.

Ordinarily, I pay scant heed to the words of my leaders in Government. But this time it is worth noting that the bank free reserves and the rate of change in the money stock are acting as if Mr. Burns means it (see two charts, both courtesy of Merrill Analysis, Box 228, Chappaqua, NY 10514).





This kind of squeeze will, of course, be a definite aid in halting the inflation rate. But the question, as always, is whether the squeeze will be retained if the market starts caving in and if business starts contracting. It's never happened before. We will shortly see how far Mr. Burns will go to protect the dollar.

Ah yes, on Friday (Feb. 23) after the close of the market and late enough so that Barron's could not catch it for this week's edition, the Fed raised the discount rate to 5.5%. The banks immediately boosted their prime rate to 6.25%, and the money market tightened its belt one more notch.

RAMBLINGS: The new short interest ratio for the NYSE is .97, which puts this to the neutral-bearish side.

One of the most brilliant rundowns of the indicators is issued by Marty Zweig each month. Marty is inventor of the Zweig put/call ratio and other outstanding indicators. There have been a small handful of outstanding young men who have entered the Wall Street scene in the past few years, and I place Zweig right at the top. The current issue of Financial World features some of those who are or have been,bearish on this market, including Janeway, Hold, Zweig and myself. (Zweig, 300 E. 48th St., NYC 10017).

By the way, I want to congratulate Al Kingdon as the new Editor-in-Chief of the New Financial World. This is a magazine which has been around a long time, it is a weekly, and I think that Al is going to make it exciting (it's getting better with each new issue). Financial World, 17 Battery Pl., NYC 10004.

Thanks to Alden Wells for the kind words in his last report. You had me blushing. Harry Schultz, you owe me a letter. If you'd stay on one continent for longer than a day or so, I'm convinced you could get one off to me.

A subscriber sent me this news clip regarding Growling Bear. All I can say is, keep him off Wall Street.

Gold bullion hit an early price of $95.50 in London on February 23, then closed at $85. This was obviously a one-day-reversal, and this means that gold will not correct some of the fantastic rise since the $60 recent low. Meanwhile, the mines will be getting a much higher average price for gold, and their profits in the months ahead should be way, way up. Their dividends should be up too.

Apologies, the chart in the last Letter of Amer. Gen. Convertible Securities was courtesy of Quote Digest, PO Box 213, Wichita, Kansas 67201.

STOCKS: I don't make the statistics on the 30 Dow Industrials, I simply tabulate them each week. Referring to the description of the Technical Charts on page 6, note that each of the Dow stocks has a potential of 6 as a "highest rating" (as opposed to a lowest rating of 0). This means that the highest potential for the DJIA under my system is 6 times 30 or 180. Last week the ratings had dropped to 31, down from 91 on January 9 of this year. Only two stocks had ratings of 4, Exxon and Allied Chemical (the latter was reviewed in the last Letter).

Dictaphone Cursed; Common Stock Declines

BRIDGEPORT, Conn. — Frank Growling Bear, a 32-year-old Penobscot-Maliseet Indian from Maine, was smiling December 8th when the New York Stock Exchange closed for the weekend.

Dictaphone Corp. stock had declined three-eighths, and Growling Bear, who was recently fired as an electronic troubleshooter at Dictaphone, had placed a curse on the corporation that morning.

"See, I told you the curse would work," Growling Bear said to reporters, "and that's just the beginning. I have put a metaphysical curse against the Dictaphone Company, and as a result it will suffer severe financial setbacks."

Growling Bear performed a full native hex ceremony on the corporation headquarters doorstep, and later said he would follow his ceremonial curse with a federal court suit and a complaint to the National Labor Relations Board.

Standard of Calif. has a rating of 3, as do Int. Nickel and Anaconda. This means that if I had to pick a package of stocks to gain points with on any rally, I would pick Allied, Exxon, St. of Calif., Nickel and Anaconda. I am including a chart of Exxon. Note that Exxon looks pretty good, but the rate of rise could not be sustained, and thus the momentum has broken down. What this chart is saying is that Exxon is acting better than the market (relative strength is up) but that the stock is not acting better than its price performance of 13 weeks ago as seen by the diving momentum. On-balance-volume in Exxon is good, but this alone is not enough to give a "strong" rating to the stock.

A second chart shown is Campbell Red Lake, an outstanding Canadian gold producer. This is a daily chart, unlike the other one which is weekly. Here we see the new high in price and the OBV. However, momentum cannot be expected to climb much above 120, and this suggests along with the giant burst in relative strength that CRK is due for some kind of correction. Along with a healthy correction in CRK, I would think a general correction in all the gold shares would be in order.

TECHNICAL CHARTS on the Dow stocks are constructed as follows: Weekly high, low and closing price for each stock is plotted.

(1) Price fluctuates above or below a 10-week moving average (MA) of price. The MA is advanced three weeks in front of price. This is done because the process has been tested and provides the best buy and sell signals.
(2) On-Balance-volume (OBV) is cumulated volume. If a stock rises on a given day, all the volume for that day is considered plus, and is added to the previous day's total. The converse is applied if the stock declines. The Wednesday figure is plotted each week on the chart.
(3) If a short interest exists in the stock, it is shown on the chart.
(4) Relative strength (RS) is a ratio and indicates the stock's action compared with the "market." The market, in this case, is the S & P 500.
(5) The Momentum index (MO) used here is the ratio of the stock's price to its own price 13 weeks ago. Thus, while relative strength (RS) gauges the current performance of the stock against the general market, MO measures the performance of a stock against its own previous level. Important: If the market is declining, rising RS in a stock does not mean that stock is rising, it simply means that the stock is declining less rapidly than the market. But rising MO always means that the stock is actually rising, regardless of the market. Rising RS and MO indicates that not only is the stock outperforming the market, but the stock is trending above its own price of 13 weeks ago. RS tells you what to buy; MO tells you when to buy.
(6) The odd-lot ratio is the ratio of odd-lot buying to selling in the individual stock. These weekly ratios are plotted on the chart in the form of 4-week moving averages. When the odd-lot ratio rises it indicates a move towards selling, a declining line indicates less selling or buying. A ratio of 500 means 500 shares sold for each 100 bought; a ratio of 50 means 50 shares sold for each 100 bought.

Each of the six indicators is worth a point. Stocks are rated from zero (least strength) to 6 (most strength).